UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

In re	Case Nos. 01-55472-JRG and 01-55473-JRG
CONDOR SYSTEMS, INC., a California corporation; CEI Systems, Inc., a Delaware corporation, Debtors. _____/	Chapter 11 Jointly Administered for Administrative Purposes Only
CONDOR SYSTEMS, INC., a California corporation, Plaintiff, vs. JOHN L. TAFT, an individual, Defendant. _____/	Adversary No. 02-5380

ORDER ON MOTIONS FOR SUMMARY JUDGMENT

I. INTRODUCTION

Before the Court are two motions for summary judgment in the above-captioned adversary proceeding, involving a dispute between the Debtor, Condor Systems, Inc. ("Condor"), and Defendant John Taft ("Taft"). Pre-petition Taft signed an employment agreement with Condor that provided for severance pay in the form of a letter of credit or an escrow account. Condor terminated Taft's employment less than one year before the petition date and now seeks to recover from Taft the severance

pay as a preference. For the reasons discussed below, the Court finds that the issuance of the letter of credit was not on account of an antecedent debt and the transfer therefore did not constitute a preference.[1]

II. FACTUAL BACKGROUND

On April 15, 1999, Condor executed a security agreement with Bank of America ("BofA") granting a blanket security interest in all of Condor's assets. On April 20, 1999, BofA filed a UCC-1 financing statement relating to that security agreement.

On April 6, 2000, Taft and Condor entered into an employment agreement ("Agreement"). Paragraph 6(a) of the Agreement provides:

> In the event that the Employee's employment under this Agreement is terminated pursuant to the provisions of Section 5(b) or 5(d), or if the Company pursuant to Section 2 does not renew the employee's Employment Period, as severance pay the Employee shall be paid a total of $500,000. Such severance pay shall be paid in the form of a standby letter of credit issued by a bank or a lump sum deposit to an escrow account at a bank designated by the Company, and thereafter shall be drawn upon or paid to the Employee in eight equal installments on the last business day of each of the eight fiscal quarters following the quarter during which Employee's employment is terminated, beginning with such fiscal quarter; *provided* that the escrow agreement will provide that all payments of Employee's severance pay will cease if Employee breaches any of the provisions of Section 7 of this Agreement. Employee shall also be entitled to continued eligibility to participate in all health, medical and dental benefit plans of the Company for which Employee was eligible immediately prior to the effective time of the termination of Employee's employment, or comparable coverage, for two years, or, if sooner, until comparable health insurance coverage is available to Employee in connection with subsequent employment or self-employment. In addition, the termination of the Employee's employment shall not accelerate the vesting of unvested Options or Stock Appreciation Rights (as such terms are defined in the 1999 Management Incentive Program) held by the Employee (if any).

Section 5(b) of the Agreement provides for the termination by Taft for good reason and section 5(d) provided for the termination of Taft by Condor without cause. Section 7 of the Agreement provides that Taft not compete with Condor for two years and not solicit Condor employees for one year.

On November 29, 2000, BofA issued an irrevocable standby letter of credit in the amount of $500,000 secured by its blanket security agreement ("Letter of Credit"). On November 30, 2000, Condor and Taft executed a Separation Agreement. Paragraph 1 of the Separation Agreement states in relevant part: "Your employment with the Company is terminated effective November 30, 2000 (the "Effective

[1] Because the Court finds that the letter of credit was not issued on account of an antecedent debt, the Court does not address the other arguments raised in these motions.

Date")." Paragraph 2 of the Separation Agreement states in relevant part: "You will be paid your earned salary and accrued vacation pay through the Effective Date on November 30, 2000." Condor filed its bankruptcy petition on November 18, 2001.

There are no material facts in dispute.

III. THE COMPLAINT AND THE MOTIONS FOR SUMMARY JUDGMENT

On September 26, 2002, Condor filed a Complaint containing three Claims. Claim 1 seeks avoidance of Taft's receipt of the Letter of Credit as a preferential transfer pursuant to § 547 of the Bankruptcy Code. Claim 2 seeks equitable relief for unjust enrichment asserting that the severance pay exceeds the cap imposed by § 502(b)(7) of the Bankruptcy Code. Claim 3 seeks injunctive relief preventing Taft from drawing any additional funds from the Letter of Credit.

On July 26, 2005, Condor filed its motion for summary judgment. In its motion, Condor argues that under In re Compton Corp., 831 F.2d 586 (5th Cir. 1987) and In re Air Conditioning, Inc., 845 F.2d 293 (11th Cir.), cert. denied, 488 U.S. 993 (1988), when Condor caused BofA to issue the Letter of Credit, a preferential transfer occurred because BofA, as issuer, acquired a security interest in the assets of Condor to secure BofA's reimbursement rights with respect to Condor's Letter of Credit obligation, which transfer was made to or for the benefit of Taft. Because that transfer was made based on the Agreement, the transfer was made on account of antecedent debt when Condor was insolvent. Taft was an insider of Condor at the time of the transfer and the transfer occurred within one year prior to the petition date. The transfer enabled Taft to receive more than Taft would receive if the case were a Chapter 7 and the transfer had not been made.

On August 25, 2005, Taft filed his opposition to Condor's motion and filed a counter motion for summary judgment. Taft opposes Condor's motion asserting, inter alia, that because the Letter of Credit was issued on November 29, 2000 and Taft's claim for the contractual severance did not arise until November 30, 2000, the effective date of his termination, there is no antecedent debt.

On September 1, 2005, Condor filed its opposition to Taft's motion for summary judgment and its evidentiary objections to the declaration of John Taft. Because the evidence objected to does not impact the Court's legal analysis regarding antecedent debt, the Court does not rule on the evidentiary objections at this time.

IV. LEGAL STANDARD

"[A] party seeking summary judgment always bears the initial responsibility of informing the . . . court of the basis for its motion, and identifying those portions of 'the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any,' which it believes demonstrate the absence of a genuine issue of material fact." Celotex Corp. v. Catrett, 477 U.S. 317, 323 (1986); quoting Fed. R. Civ. P. 56(c). If the movant meets this burden of production the nonmoving party must go beyond the pleadings and by affidavit, deposition, answers to interrogatories, and admissions on file, designate specific facts showing that there is a genuine issue for trial. Id. The nonmovant's version of the facts must be accepted and all inferences from the underlying and undisputed facts must be drawn in favor of the nonmovant. Bishop v. Wood, 426 U.S. 341 (1976); United States v. Dyebold, 369 U.S. 654 (1962). A material fact is one that is relevant to an element of a claim or defense, and whose existence might affect the outcome of the case. United States v. Grayson, 879 F.2d 620 (9th Cir. 1989).

V. DISCUSSION

Section 547(b)[2] gives the trustee[3] the power to avoid certain transfers made before the bankruptcy filing that enable a creditor to receive more than the creditor would otherwise receive if,

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[2] Specifically, § 547(b) permits the trustee to avoid any transfer of an interest of the debtor in property –

(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made –
  (A) on or within 90 days before the date of the filing of the petition; or
  (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
(5) that enables such creditor to receive more than such creditor would receive if –
  (A) the case were a case under chapter 7 of this title;
  (B) the transfer had not been made; and
  (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

[3] Section 1107 of the Bankruptcy Code grants debtors-in-possession such as the Debtor the powers of a trustee. 11 U.S.C. § 1107. Therefore, Condor has the authority to sue under § 547 to set aside preferential transfers. 5 *Collier on Bankruptcy* ¶ 547.11[2][c] (15th ed. rev. 2005).

instead, the creditor were limited to its share of a distribution from a Chapter 7 liquidation. Section 547(g) places the burden of proving the avoidability of a transfer on Condor. 11 U.S.C. § 547(g).

Condor has not shown that the transfer to Taft was on account of an antecedent debt.[4] Pursuant to Compton, the indirect transfer to Taft occurred when the Letter of Credit was issued and the increased security interest was pledged. Thus, the transfer in this case occurred on November 29, 2000.

Under § 547(b)(2), the transfer must be "for or on account of an antecedent debt owed by the debtor before such transfer was made." If the transfer occurred on November 29, 2000 and Taft was terminated on November 30, 2000, the issuance of the Letter of Credit would not be on account of an antecedent debt since the severance obligation was not incurred until after Taft was terminated.

Taft asserts that an employee's contractual right to severance in connection with a termination of employment arises when the employee is terminated under Southmark Corp. v. Marley (In re Southmark Corp.), 62 F.3d 104 (5th Cir. 1995), cert. denied, 516 U.S. 1093 (1996) ("Southmark I") and In re G. Survivor Corp., 217 B.R. 433 (Bankr. S.D.N.Y. 1998).

In Southmark I, the debtor signed an employment contract with D. Vinson Marley in 1982 that required the debtor to pay severance benefits in the event that the debtor terminated the contract. In 1986, the debtor transferred all of its employees to a wholly owned subsidiary of the debtor and in turn leased the employees back to the debtor. On April 28, 1989, the debtor and Marley executed a settlement agreement and Marley received a check for $400,000 in exchange for releasing the debtor from all severance obligations under the employment contract. The debtor filed for bankruptcy on July 14, 1989 and subsequently sued Marley for return of the $400,000 as a preference.

The Fifth Circuit stated:

> Southmark first contends that it incurred its debt when it and Marley signed the employment contract that called for payment of severance benefits in the event of termination. The Code defines "debt" as "liability on a claim." 11 U.S.C. § 101(12) (1988). A debtor incurs a debt when he becomes legally obligated to pay it. *In re Emerald Oil Co.*, 695 F.2d 833, 837 (5th Cir. 1983); *see also Sherman v. First City Bank (In re United Sciences of Am.)*, 893 F.2d 720, 724 (5th Cir. 1990) (explaining, in setoff

[4] Because the Court finds that the Letter of Credit was not issued on account of an antecedent debt, Condor cannot prevail on its preference claim, which is the only claim on which Condor seeks summary judgment. The Court does not address the other elements of a preference at this time but notes that it is likely Condor would prevail on each of the other elements of its preference claim.

> context, that bank incurred debt when right to payment arose, not when bank asserted right).
>
> Under the Code, a party to an executory contract has a claim against the debtor only when the debtor has rejected the contract. *See* 11 U.S.C. §§ 365(g), 502(g) (1988); *Wainer v. A.J. Equities*, 984 F.2d 679, 684-85 (5th Cir. 1993) (per curiam). Consequently, a debtor who breaches an executory contract incurs a debt only at the time of breach. *See Wainer*, 984 F.2d at 685. Courts have reached the same conclusion in preference actions. *See In re Energy Coop.*, 832 F.2d 997, 1002 (7th Cir. 1987) (holding that purchaser incurred debt when it anticipatorily repudiated contract to buy crude oil); *In re Gold Coast Seed Co.*, 751 F.2d 1118, 1119 (9th Cir. 1985) (holding that seed buyer became obligated to pay at time of shipment, not when parties executed contract for future shipment).
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> In *Intercontinental Publications* [131 B.R. 544 (Bankr. D. Conn. 1991)], the debtor terminated an employee whose employment contract provided for severance benefits payable in installments after termination. The debtor brought a preference action, and the bankruptcy court considered whether the installment payments were on account of an antecedent debt. The court held that the debtor incurred its debt when the debtor terminated its employee. 131 B.R. at 550. Likewise, we conclude that Southmark incurred its debt to Marley at the time it terminated hin.

Southmark I, 62 F.3d at 106.

In G. Survivor, the debtor and Eli Harari entered into a pre-petition employment agreement that provided for Harari's compensation and severance pay. Upon the acquisition of the debtor pre-petition, Harari was paid $930,000 less withholding taxes in exchange for his resignation. The court, relying on Southmark I, held that the portion of the transfer that represented severance pay arose when the debtor terminated Jarari, but denied summary judgment on the basis that there was an issue of fact as to whether the $930,000 payment was solely for severance pay or was part of the acquisition transaction.

Condor cites no case holding that a terminated employee who received a pre-petition severance benefit received that benefit on account of an antecedent debt for preference purposes. Rather, Condor seeks to distinguish the interpretation of antecedent debt in Southmark I by arguing that Southmark I was broadened by the Fifth Circuit in a subsequent case, Southmark Corp. v. Schulte Roth & Zabel (In re Southmark Corp.), 88 F.3d 311 (5th Cir. 1996), cert. denied, 519 U.S. 1057 (1997) ("Southmark II"). In Southmark II, the debtor sued the attorneys for minority interest shareholders who, pre-petition, settled their proxy contest and related litigation. As part of the settlement, the attorneys were paid approximately $3.3 million. The debtor sought recovery of the fees as a preference. The Fifth Circuit determined that the attorneys fees incurred by the minority shareholders was a claim under the Bankruptcy Code prior to the execution of the settlement agreement. The Fifth Circuit stated:

> We note at the outset that we are in agreement with the bankruptcy court's conclusion that, prior to the execution of the Agreement, the Parks Group's demand for costs and attorneys' fees did constitute a "claim" for purposes of the bankruptcy code. Although the right to payment of these expenditures may have been disputed and even contingent, such a right is nevertheless encompassed by the expansive statutory definition of the term "claim." This conclusion also comports with the legislative history of the statute. The House and Senate Reports state that "[b]y this broadest possible definition [of the term 'claim'] ... the bill contemplates that all legal obligations of the debtor, *no matter how remote or contingent*, will be able to be dealt with in the bankruptcy case. It permits the broadest possible relief in the bankruptcy court." Thus, like the bankruptcy court, we conclude that, prior to the execution of the Agreement, the Parks Group's amicable and judicial demands for costs and attorneys' fees were "claims" within the intendment of the bankruptcy code. On the other hand, we cannot agree with the bankruptcy court's conclusion that this "claim" was not a "debt." Instead, we conclude that the claim is also a debt.
>
> The legislative history of the bankruptcy code explains the relationship between debt and claim: "The terms 'debt' and 'claim' are coextensive: a creditor has a 'claim' against the debtor; the debtor owes a 'debt' to the creditor." Moreover, the Supreme Court has held that the meanings of the terms "debt" and "claim" are coextensive. Indeed, we have proclaimed that, based on Supreme Court authority, "there is no distinction between 'debt' and 'claim' for purposes of the Bankruptcy Code."
>
> In the absence of a compelling reason why this line of authority would not be applicable to the instant case, we conclude that, as the Parks Group had a "claim" for these expenditures prior to the execution of the Agreement, a "debt" of Southmark also existed for these expenditures prior to the execution of the Agreement. Thus, the $3.3 million transfer was on account of an antecedent debt owed by Southmark.

Southmark II, 88 F.3d at 317 (emphasis in original) (footnotes omitted). The Southmark II court further noted that "[a]lthough the instant case presents a rare if not unique fact situation, it nevertheless falls within the broad statutory language of the preference statute. This conclusion is not only consistent with the statute and the case law, but also comports with the general observation that a settlement agreement resolves preexisting claims." Id. at 318.

Without elaborating, Condor asserts that the facts of Southmark II are closer to those in this case than the facts in Southmark I and is consistent with Ninth Circuit authority under Aerfi Group P.L.C. v. Barstow (In re Markair, Inc.), 240 B.R. 581 (Bankr. D. Alaska 1999) ("Aerfi") and the cases cited therein. The Court disagrees. First, Southmark I deals with a pre-petition employment agreement which is nearly identical to the case before this Court while Southmark II deals with the right to attorneys' fees in litigation. Second, Southmark I is consistent with Aerfi and the cases cited therein.

In Aerfi, the creditor leased jet aircraft to the debtor. The lease agreements contained rent and maintenance obligations. Within 90 days of the debtor filing its bankruptcy petition, the debtor executed a security agreement with the creditor to secure the payment of past and future rental and maintenance

reserves and the performance of obligations under the lease agreements. The case converted to chapter 7 and the trustee sued the creditor to void the security agreement and recover payments made to the creditor during the preference period. In holding that the security agreement secured antecedent debts, the bankruptcy court extensively reviewed Ninth Circuit authority regarding antecedent debt for preference purposes.

In In re Bullion Reserve, 836 F.2d 1214 (9th Cir.), cert. denied, 486 U.S. 1056 (1988), the debtor obtained funds from investors that it used to invest in bullion on behalf of the investors. The chapter 7 trustee sought to recover as a preference payments the debtor made to one investor as a result of the liquidation of bullion held by the debtor on behalf of that investor. In analyzing the preference statute, the Bullion Reserve court held that the investor became a creditor when the debtor purchased bullion for the investor and not when the investor liquidated the bullion held for him. Id. at 1219.

In In re Futoran, 76 F.3d 265 (9th Cir. 1996), the debtor and his ex-wife entered into a marital termination agreement that provided for monthly payments to the ex-wife. Shortly before filing his bankruptcy petition, the debtor paid his ex-wife a lump sum payment in cancellation of his future obligations under that agreement. The chapter 7 trustee sought to recover the lump sum payment from the ex-wife as a preference. The Futoran court held that, as with an installment loan, the debtor became liable to his ex-wife for the monthly payments when the marital termination agreement was entered into and the lump sum payment was on account of an antecedent debt. Id. at 267.

In In re United Energy, 944 F.2d 589 (9th Cir. 1991), investors invested in solar energy production modules. The modules did not produce any energy and investors were paid from the proceeds of new investors. The court looked at antecedent debt in the context of the fraudulent transfer statute. The United Energy court found that the restitution rights against a debtor for its fraudulent participation in a Ponzi scheme were payments for an antecedent debt. Id. at 595.

Based on the analysis of Ninth Circuit authority and the legislative history, the Aerfi court found that the transfers in payment and the security agreement to secure the rent, maintenance reserves, and maintenance obligations in the preexisting leases were for "antecedent debt." Aerfi, 240 B.R at 592.

The breach of contract analysis in Southmark I, holding that the obligation to pay severance arose upon the termination of Taft, is not inconsistent with Aerfi or the various Ninth Circuit law cited

therein. When Taft and Condor signed the Agreement, they entered into an executory contract that provided for compensation and other benefits and the Separation Agreement specifically continues Taft's earned salary and accrued vacation pay through November 30, 2000. The Agreement also sets forth what would be the obligations of the parties should the parties terminate the Agreement. However, until Taft was terminated on November 30, 2000, Taft had no right to the severance pay specified in the Agreement. Condor was not legally obligated to pay Taft the severance amount until it actually terminated Taft. Taft held no "claim" for the severance pay prior to the execution of the Separation Agreement and no corresponding "debt" of Condor existed for this pay prior to the execution of the Separation Agreement. Thus, under the reasoning of Southmark I, the issuance of the Letter of Credit was not on account of an antecedent debt.

VI. CONCLUSION

For the foregoing reasons, the issuance of the Letter of Credit was not on account of an antecedent debt. Taft's motion for summary judgment is granted and Condor's motion for summary judgment is denied.

DATED: _____

_____
JAMES R. GRUBE
UNITED STATES BANKRUPTCY JUDGE

Case Nos. 01-55472-JRG and 01-55473-JRG

UNITED STATES BANKRUPTCY COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

CERTIFICATE OF SERVICE

I, the undersigned, a regularly appointed and qualified Judicial Asssistant in the office of the Bankruptcy Judges of the United States Bankruptcy Court for the Northern District of California, San Jose, California hereby certify:

That I am familiar with the method by which items to be dispatched in official mail from the Clerk's Office of the United States Bankruptcy Court in San Jose, California processed on a daily basis: all such items are placed in a designated bin in the Clerk's office in a sealed envelope bearing the address of the addressee, from which they are collected at least daily, franked, and deposited in the United States Mail, postage pre-paid, by the staff of the Clerk's Office of the Court;

That, in the performance of my duties, on the date set forth below, I served the **ORDER ON MOTIONS FOR SUMMARY JUDGMENT** in the above case on each party listed below on the next page by depositing a copy of that document in a sealed envelope, addressed as set forth, in the designated collection bin for franking, and mailing.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on _____ at San Jose, California.

_____
LISA OLSEN

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